

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:WR:RMD:DEN:TL-N-1327-99  
RAVarra

date:

to: Case Manager, Group 4209  
Attn: Mac Marriott

from: District Counsel, Rocky Mountain District, Denver

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subject: **Request for Advisory Opinion**  
**Deemed Additional Compensation**  
**Taxpayer:** [REDACTED]

We are writing in response to your request for advice regarding the tax treatment of certain transaction between the taxpayer and the trustee of [REDACTED]'s bankruptcy estate.

**ISSUES**

1. Whether additional compensation must be recognized by a corporate officer for payments made by the corporation to the bankruptcy estate of the officer:
  - a. to allow the officer and his family to retain items of tangible personal property, and
  - b. to resolve a claim that payments ostensibly made under an employment contract are disguised payments for stock.
2. Whether the corporation is entitled to deduct the payments made to the trustee to:
  - a. allow the officer and his family to retain items of personal property, and
  - b. to settle the dispute about whether payments under an employment contract constitute disguised payments for stock.
3. Whether a debtor is entitled to a deduction under I.R.C. § 212 for payments made by the debtor's employer to the debtor's bankruptcy trustee to:

a. allow the debtor to retain property that is property of the estate and, to settle assertions that certain transfers are avoidable, and

b. to settle the trustee's claim that payments to the debtor designated as compensation in an employment contract are really property of the estate.

Alternatively, whether the debtor can amortize the portion of such payments attributable to the employment contract over the life of the employment contract.

4. Whether return information from a bankruptcy estate can be disclosed to the debtor.

#### CONCLUSIONS

1. a. A corporation's payment to the trustee of a corporate officer's bankruptcy estate to allow officer and his family to retain items of tangible personal property constitutes indirect compensation to officer that should be included in his income.

b. To the extent that payments were made by the corporation to compensate an officer for releasing his interest in the corporation's stock, the payment constitutes a sale or exchange of that stock by the officer that is taxable as a capital gain. Payment of the proceeds from that sale or exchange to the trustee is not a taxable transaction under I.R.C. § 1398(f)(1).

2. a. The corporation can deduct the amount paid to the trustee to allow the corporate officer and his family to retain items of tangible personal property as compensation paid indirectly to the officer.

b. The corporation cannot deduct amount paid to the officer to compensate him for releasing his rights in the corporation's stock because this constitutes a redemption of stock by the corporation.

3. a. The payments made by the corporation on behalf of its officer to allow the officer and his family to retain items of tangible personal property are not deductible by the corporate officer. These payments are, instead, the cost basis of the assets that were retained rather than turned over to the trustee.

b. The corporate officer is not entitled to deduct the payment by the corporation to resolve the dispute over whether

payments under the officer's employment contract with the corporation were for services or in exchange for the officer's release of corporate stock. This payment is, in effect, merely the turning over of proceeds from the sale of assets of the estate, which is a nontaxable event under I.R.C. § 1398(f)(1).

4. Upon written request, the returns of the bankruptcy estate can be opened for inspection by or disclosed to the debtor. In addition, return information can similarly be inspected by or disclosed to the debtor, if it is determined that such disclosure will not seriously impair Federal tax administration.

#### FACTS

██████████ ("██████████") was the sole shareholder of ██████████ or "the taxpayer") (now known as ██████████). ██████████ was a holding company that owned various entities involved primarily in the ██████████, ██████████, and ██████████ businesses. An involuntary bankruptcy petition under Chapter 11 of the Bankruptcy Code was filed against ██████████ on ██████████, and an order for relief was filed on ██████████, when ██████████ consented to the bankruptcy proceeding.

The plan of reorganization originally proposed by ██████████ allowed ██████████ to retain a ██████████% interest in the company, with options to purchase the remaining equity. A subordinated debenture holder objected under 11 U.S.C. § 1129(b)(2)(B)(ii) to ██████████ receiving any interest in the company. ██████████ threatened to propose a plan that would provide nothing to the subordinated debenture holder and nothing to ██████████ other than compensation. Such a plan could arguably be confirmed under the cram down provisions in 11 U.S.C. § 1129(b)(2). However, the subordinated debenture holder could argue that the payments to ██████████ that were being called compensation were really payment for his equity interest. Ultimately an agreement was reached with the subordinated debenture holder in which the debenture holder was paid a portion of his claims and payments were made to ██████████ under a so-called compensation agreement. The amended plan of reorganization was confirmed on ██████████.

The compensation agreement in the ██████████ confirmed plan of reorganization provided for ██████████ to receive \$██████████ per year for ██████████ years, plus various other fringe benefits, perquisites, and additional compensation.

██████████ filed a bankruptcy petition under Chapter 7 of the Bankruptcy Code on ██████████. The trustee in ██████████'s

personal bankruptcy believed that certain insider transactions in the [REDACTED] bankruptcy might be assets of [REDACTED]'s personal bankruptcy estate. The trustee's primary concern was that the employment contract between [REDACTED] and [REDACTED] was a means to disguise payment to [REDACTED] for his equity interest in [REDACTED] and its subsidiaries, rather than a legitimate contract for future services. The trustee, through his attorney, threatened to file an objection to [REDACTED]'s discharge.

The trustee also became concerned about certain transfers of assets by [REDACTED] to family members that were made prior to his personal bankruptcy. The trustee believed that certain transfers made by [REDACTED] to his children could be avoided and the assets brought into the bankruptcy estate.

A third issue that arose was [REDACTED]'s desire to retain items of personal property and the price he would have to pay the estate to retain these assets.

There were a number of letters exchanged between [REDACTED], the attorney for the trustee, and [REDACTED], the attorney for [REDACTED]. In a letter dated [REDACTED], [REDACTED] offered a global settlement for \$ [REDACTED], payable \$ [REDACTED] upon court approval and the balance by the end of the year. The trustee's attorney estimated that \$ [REDACTED] of this amount represented the value of assets to be retained by [REDACTED] and the value of avoidable transfers, while \$ [REDACTED] represented the amount of the settlement allocable to the post-petition compensation issue. This settlement offer was accepted.

Pursuant to the settlement, a payment of \$ [REDACTED] was made by cashier's check to the trustee on [REDACTED], and a payment of \$ [REDACTED] was made by wire transfer to the trustee on [REDACTED]. These payments were made by [REDACTED], rather than by [REDACTED]. The receipt signed by the trustee for the first payment states that the payments "are in full settlement, among other things, of all claims that the Trustee may have against either Debtor or [REDACTED] that relates to the assertion that a portion of the remuneration provided under the Employment Agreement by [REDACTED] and among the Debtor and [REDACTED], dated [REDACTED], was for services provided by the Debtor to [REDACTED] prior to the date of such agreement." The receipt for the second payment contains the same language, except the clause "among other things" is omitted. The trustee has indicated that references to the other claims were omitted and the phrase "among other things" included in the first receipt at the request of [REDACTED].

On [REDACTED], the employment agreement between [REDACTED] and [REDACTED] was amended to provide that [REDACTED] would receive \$ [REDACTED] per year for [REDACTED] years.

The trustee filed a Form 1041 for the year [REDACTED] showing substantial net losses. The trustee included the \$ [REDACTED] received in the settlement in income. The trustee has stated that the payment was reported as income out of an abundance of caution, since it had no tax effect to the estate.

#### ANALYSIS

##### Issue 1 - Taxability of Payments Made to the Trustee:

###### a. **Tangible Personal Property**

The trustee of [REDACTED]'s personal bankruptcy had a claim against [REDACTED] to turn over assets that the trustee contended were assets of the estate. There was no dispute that some of the assets in question were assets of the estate that the trustee had a right to receive from [REDACTED]. The character and ownership of other assets were disputed. To allow [REDACTED] to retain assets that were clearly assets of the estate and to resolve the controversy over the disputed assets, an agreement was reached that entitled the trustee to receive cash, rather than any of the assets. The cash payment, though, was made by the taxpayer, rather than by [REDACTED].

When a corporation makes payments on behalf of one of its officer, the payments constitute additional income to the officer. Huff v. Commissioner, 80 T.C. 804 (1983). In this case, [REDACTED] entered into an agreement with the trustee that allowed him to retain assets that constituted, or might be found to constitute, property of the estate upon payment of an agreed sum to the trustee. [REDACTED], therefore, had the obligation to make the payment to the trustee. The payment of that obligation by [REDACTED] was a payment on behalf of [REDACTED] that constitutes taxable income to [REDACTED].<sup>1</sup>

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<sup>1</sup> Rather than a payment on behalf of [REDACTED], it might be argued that the substance of the transaction was a purchase of the assets by [REDACTED] from the estate and a distribution of the assets to [REDACTED]. In that case, the full fair market value of the assets would constitute taxable income to [REDACTED]. Treas. Reg. § 1.61-2(d)(1).

**b. Stock**

The trustee also made a claim that part of the amount being paid by [REDACTED] to [REDACTED] under an employment contract was being paid in exchange for [REDACTED]'s stock in [REDACTED], rather than for services rendered. To the extent that [REDACTED] was receiving payments in exchange for his stock, the amount received would be a capital transaction. Depending on his basis in the stock, he would have either a capital gain or a capital loss, rather than ordinary income from compensation. This payment by [REDACTED] to the trustee would nonetheless have tax consequences to [REDACTED], though.

**c. Taxability to Trustee**

The taxpayer argues that the payments by [REDACTED] to the trustee should not be taxable to [REDACTED], because the trustee reported those payments as income. The taxpayer's argument is based on the premise that it was proper for the trustee to include the receipt of cash from [REDACTED] in income, which is not necessarily correct. The taxpayer's argument is also based on the assumption that the transaction could not be taxable to both [REDACTED] and the trustee, which is also not necessarily correct.

A transfer of assets from a debtor to the trustee of the debtor's bankruptcy estate is not a taxable disposition, unless the transfer is a sale or exchange. I.R.C. § 1398(f)(1). It might be argued that the transfer of funds to the trustee in this case was a non-taxable transfer under I.R.C. § 1398(f)(1) because the trustee was simply receiving the equivalent of the assets of the estate from the debtor. If this were the case, the receipt of funds from [REDACTED] (on behalf of [REDACTED]) by the trustee would not be taxable to the trustee.

With respect to the portion of the payments made to allow [REDACTED] and his family to keep specific assets, we think the better position is that this was a taxable sale or exchange by the trustee. The substance of the transaction was that the trustee sold the assets of the estate to the debtor for the cash payment received by the trustee. The payment of cash in lieu of transferring the assets to the trustee is, in effect, a sale of the assets by the trustee. Under I.R.C. § 1398(f)(1) this would be a taxable transaction.

The trustee has a stronger argument for excluding from income the portion of the payments he received that is attributable to his claim that part of the amount paid to [REDACTED] under his employment agreement with [REDACTED] was payment for [REDACTED]'s [REDACTED] stock. The trustee could argue that there was no sale or

exchange of the stock or the trustee's interest in the stock to [REDACTED]. Instead, the trustee could contend that he was simply receiving the proceeds from the stock that [REDACTED] had received when he surrendered this stock pursuant to [REDACTED]'s plan of reorganization. Under 11 U.S.C. § 541(a)(6), the proceeds of assets of the estate are also assets of the estate. The trustee's receipt of proceeds from [REDACTED]'s sale or exchange of assets of the estate would not be taxable to the trustee.

The trustee's inclusion in income of the receipt of cash from [REDACTED] does not proscribe the taxability of that amount to [REDACTED] as well. [REDACTED]'s payment on behalf of [REDACTED] can be taxable to [REDACTED] and the receipt of that payment taxable to the trustee as well. Oftentimes payments by a corporation on behalf of its officers will be taxable to both the recipient of the funds and to the officer. The payment is taxable as income to the provider of the goods or services as income received in the ordinary course of business and is also taxable to the officer as indirect compensation.

Issue 2 - Deductibility by the Taxpayer of Payments Made to the Trustee:

**a. Tangible Personal Property**

As payments of compensation to [REDACTED], [REDACTED] would generally be entitled to a deduction for the amounts paid. I.R.C. § 162(a)(1). It might be argued that the payments are not deductible to [REDACTED] because [REDACTED] had no obligation to pay the liability. See Reade Mfg. Co. v. United States, 301 F.2d 803 (3d Cir. 1962). The better position, though, is that the payment to the trustee was an indirect payment of compensation to [REDACTED] and therefore deductible by [REDACTED]. This position is bolstered by the fact that [REDACTED]'s employment contract with [REDACTED] was amended to reduce other compensation to [REDACTED] contemporaneous with the payment to the trustee. To the extent that the payments by [REDACTED] to the trustee were made on [REDACTED]'s behalf in order to compensate [REDACTED] for services rendered to [REDACTED], the payment was properly deducted by [REDACTED] as compensation.

**b. Stock**

To the extent that the taxpayer was paying the trustee as a means of providing an additional benefit to its officer, the taxpayer would be entitled to deduct this payment as compensation to the officer. If, on the other hand, the trustee's argument is correct, and a portion of the payment by the taxpayer was to compensate [REDACTED] for giving up his [REDACTED] stock, rather than for services, the payment would not be compensation. Under I.R.C.

§ 311(a)(2), a corporation does not recognize any gain or loss on a distribution of property in exchange for its own stock. When a corporation acquires its stock from a shareholder, the transaction is treated as a redemption of that stock. I.R.C. § 317(b). A redemption that is in complete redemption of the stock of the corporation held by a shareholder is treated as a distribution in exchange for the stock. I.R.C. § 302(a) and (b)(3). Under these provisions, ██████ cannot recognize any gain or loss on any portion of the payments that ██████ made to ██████ in exchange for his ██████ stock.

Issue 3 - Deductibility by ██████ of Payments Made to the Trustee

██████ argues that he, also, should be entitled to a deduction under I.R.C. § 212 for the payments to the trustee, either as a current expense in the year the payments were made or amortized over the life of his employment contract. He asserts that, if he must include the payments in income as payments on his behalf, he then indirectly made the payments and should be entitled to a deduction for the payments.

**a. Tangible Personal Property**

Only a portion of the trustee's claim relates to the employment contract between ██████ and ██████; the remainder of the trustee's claim was against specific tangible assets held by ██████ and his family. To the extent that payments were made to the trustee to allow ██████ and his family to retain assets that were, or arguably were, assets of the estate, there is no basis for deducting such payments. The payments were either transfers of the equivalent of assets of the estate to the trustee, which would be a nontaxable event under I.R.C. § 1398(f)(1), or they were purchases of assets of the estate from the trustee, in which case, the amount paid would be the cost basis of the assets in the hands of ██████ and his family.

**b. Stock**

The portion of the payments to the trustee that were made to satisfy the trustee's claim against amounts payable to ██████ by ██████ under the employment contract are also not deductible by ██████. The trustee did not claim that he had a right to any portion of the payments to ██████ that were made for future services rendered and he would not have a right in any such payments. 11 U.S.C. § 541(a)(6). The trustee's claim was that a portion of the payments to be made by ██████ to ██████ were in exchange for stock in ██████ held by ██████ on the day that ██████ filed his bankruptcy petition. The trustee's claim was therefore

a claim that [REDACTED] would be receiving proceeds from the sale of asset of the estate, which the trustee would have a right to receive under 11 U.S.C. § 541.

The origin or character of the claim made against a taxpayer determines whether or not payments made to settle that claim are deductible. United States v. Gilmore, 372 U.S. 39 (1963). In this case, the claim against [REDACTED] was that he was receiving payments in exchange for an asset that constituted an asset of the estate. The claim was not against income for future services. The origin of the claim was a personal transaction that is nontaxable under I.R.C. § 1398(f)(1).

The trustee claimed that a portion of the annual payments being made to [REDACTED] by [REDACTED] constituted payments for [REDACTED] stock owned by [REDACTED] on the date that he filed his bankruptcy petition. Rather than turning over or assigning a portion of the annual payments to the trustee, [REDACTED] agreed to currently pay a lump sum amount to the trustee. The payments were made to satisfy the trustee's claim to [REDACTED] stock held by [REDACTED] on the date he filed his bankruptcy petition. [REDACTED] may have been motivated to agree to the payments by an interest in protecting the agreement with [REDACTED] and [REDACTED] may have been motivated to make the payments by an interest in protecting its confirmed plan of reorganization, but the claim satisfied by the payments was a claim by the trustee to the stock (or its proceeds) as an asset of the estate.

[REDACTED] is therefore not entitled to a deduction for any portion of the payments made to the trustee, either in the year the payment was made or amortized over the life of his employment contract.

#### Issue 4 - Disclosure of Estate Return Information to the Debtor:

In an individual Chapter 7 or Chapter 11 bankruptcy case, the returns of the bankruptcy estate will be opened for inspection by or disclosed to the debtor upon written request. I.R.C. § 6103(e)(5)(B). Return information will likewise be made available to the debtor if it is determined that such disclosure will not seriously impair Federal tax administration. I.R.C. § 1398(e)(7). [REDACTED] therefore does have a right to look at the returns of his bankruptcy estate and, unless it is determined that it will seriously impair Federal tax administration, to the return information of the estate.

**DISCLOSURE STATEMENT**

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

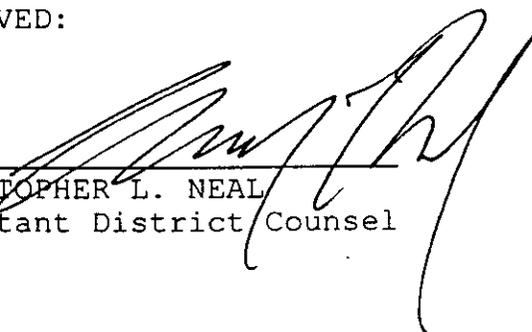
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If you have any questions regarding this memorandum, please contact Robert A. Varra.

  
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ROBERT A. VARRA  
Attorney

  
\_\_\_\_\_  
SARA J. BARKLEY  
Attorney

APPROVED:

  
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CHRISTOPHER L. NEAL  
Assistant District Counsel